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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940

NOS. 242 AND 243.

IN THE MATTER OF THE REORGANIZATION OF PITTSBURGH RAILWAYS COMPANY, a Corporation, Debtor, and PITTSBURGH MOTOR COACH COMPANY, a Corporation, Subsidiary.

PHILADELPHIA COMPANY and Certain Underliers, Petitioners,

v.

WALTER L. DIPPLE, JAMES P. McARDLE, BEN PAUL BRASLEY and THOMAS J. HOFFMAN, a Committee Known as the Tort Creditors' Committee, and CITY OF PITTSBURGH, Respondents.

BRIEF FOR RESPONDENTS.

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BRIEF FOR RESPONDENTS.

I.

OPINIONS BELOW.

The opinion of the District Court (McVicar, J.) has not yet been officially reported; it appears at pages 78 to 83 of the Record. The opinion of the Circuit Court of Appeals (Maris, C. J.) is reported in 111 F. (2d) 932, and will be found at pages 104 to 110 of the Record.

II.

JURISDICTION.

The Circuit Court of Appeals entered its orders on April 30, 1940 (R. 110). On June 12, 1940, said orders were vacated (R. 111, 112), and amended orders were entered (R. 112, 113). No petition for rehearing was filed. The jurisdiction of this Court is invoked under Sec. 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925, Chap. 229, Sec. 1, 28 U. S. C. A. Sec. 347, since this is a cause on which final orders of a Circuit Court of Appeals have been entered. The petitions for writs of certiorari were filed on July 15, 1940, and the writs were granted October 14, 1940 (R. 115).

III.

COUNTER-STATEMENT OF THE CASE.

The Pittsburgh Railways Company was organized by a special Act of the Pennsylvania Legislature in 1871. The Pittsburgh Railways System is composed of 580 miles of track, car barns, repair shops, incline properties and buses. The Pittsburgh Railways Company is the owner of a portion of the track; the remainder of the track has been operated by it since 1902 by virtue of operating agreements and leases from 55 separate underlying companies (R. 62). All of its capital stock is owned by the Philadelphia Company, one of the petitioners herein (R. 75). The Pittsburgh Railways Company controls the stock of certain of the underliers; the stock of the other underliers is owned by other interests.

The lease and operating agreements with the underliers require the Pittsburgh Railways Company to pay expenses of operation and ordinary maintenance, and all Federal, State, County and municipal taxes assessed

against the underliers, or which by any present or future law or by contract the underliers may be required to pay (R. 7). Prior to the date of these proceedings, all tax payments theretofore payable by the underliers had been paid by the Pittsburgh Railways Company (R. 7). On May 10, 1938, the Pittsburgh Railways Company together with the Pittsburgh Motor Coach Company, a wholly owned subsidiary, filed voluntary petitions in the District Court of the United States for the Western District of Pennsylvania, to effect a plan of reorganization under the provisions of Section 77B of the Bankruptcy Act. Orders were made continuing the debtors in possession, with authority to operate their businesses (R. 1). On June 14, 1938, Trustees were appointed for the debtor Railways Company, and the Trustees were authorized to preserve, maintain, manage and operate and keep in good order, condition and repair, the property and estate in possession of and/or owned by the debtor, to manage and conduct its business, and to pay all taxes and assessments due or to become due upon the property in possession of and/or owned by the debtor (R. 6).

The Trustees continued to operate the business of the debtor Railways Company. Pursuant to the court order, the Trustees have since their appointment been operating the business of the debtor, using in their operation the properties of the underliers.

On March 10, 1939, the Trustees of the debtor Railways Company petitioned the District Court for instructions with respect to the payment as an administration expense of certain taxes assessed against the debtor, the subsidiary and the underliers (R. 6).

None of the taxes of the underliers was assessed against the Pittsburgh Railways Company. The obligation of the debtor with respect to these taxes arose under the lease and operating agreements with the 55 underliers, which provided that the Railways Company should

pay all taxes assessed against the underliers (R. 7). The taxes of the debtor involved are the Pennsylvania Capital Stock Tax, Pennsylvania Corporate Net Income Tax and Pennsylvania and Federal Social Security Taxes, some of which taxes had accrued and become payable subsequent to the filing of the petition for reorganization and some of which had accrued prior thereto. The taxes of the underlying companies involved are Pennsylvania Capital Stock Taxes, Pennsylvania Corporate Net Income Taxes, Pennsylvania Corporate Loans Taxes and Federal Income Taxes, some of which taxes had accrued and become payable subsequent to the filing of the petition for reorganization and some of which had accrued prior thereto. The taxes of the subsidiary involved are Pennsylvania Capital Stock Tax and State and Federal Social Security Taxes, all of which became due after the filing of the petition for reorganization, and the employer's share of the Federal Old Age Benefits tax, which became payable prior to the filing of the petition (R. 8).

The Trustees' petition was referred to a Special Master, Watson B. Adair (R. 21). Objections to the payment of the taxes were filed by the Tort Creditors' Committee, intervenor (R. 21). Objections to such payment were made by the City of Pittsburgh, a large creditor (R. 57).

Testimony was adduced before the Master, including the fact that no decision had been reached by the Trustees as to which, if any, of the underliers would be included in the plan of reorganization. There was testimony that no determination had been made with respect to the net earnings of each of the underliers (R. 63). The Trustees neither affirmed nor disaffirmed the leases and operating agreements between the debtor Railways Company and the 55 underliers (R. 62).

On August 22, 1938, the Master filed his report (R. 55 to 72) recommending that the taxes of the debtor and

subsidiary which had accrued subsequent to the filing of the petition for reorganization should be paid by the Trustees, and that the taxes of the debtor and the subsidiary which had accrued prior to the filing of the petition, or about which there was some doubt as to when they accrued, *and all the taxes of the underliers, should not be paid by the Trustees at present.* His decision as to the nonpayment of the taxes of the underliers, whether accrued before or after the filing of the petition for reorganization, was predicated upon the fact that it was uncertain that any of the leases would be affirmed by the Trustees, and that in the absence of any evidence that the net earnings of each underlier were equal to its taxes, payment of the taxes might result in a preferment or overpayment. It was held further, that certain claims of the debtor against the underliers might extinguish any existing equities (R. 67).

Exceptions to the Master's Report were filed by the Philadelphia Company and certain of the underliers and by Samuel H. Putnam, a creditor (R. 72, 76, 77, 78). Argument was held before the Hon. Nelson McVicar, District Judge. Following the argument, counsel for the Trustees filed a recommendation with Judge McVicar in which they recommended that all of the taxes set forth in Trustees' petition for instructions be paid, save certain Federal taxes of the underliers and the underliers' corporate net income taxes, until their liability therefor should be determined (R. 93). On October 26, 1939, Judge McVicar filed an opinion holding that the taxes of the underliers be paid, with certain minor exceptions. The District Court held that the Pittsburgh Railways System had been operated as a unit since 1902, and that the income derived from the various underliers had been kept in one fund and treated as one fund, and, therefore, held that the taxes of the underliers should

be treated as taxes of the debtor (R. 78 to 83). The Court thereupon entered an order directing the Trustees to pay all the taxes of the debtor, the underliers and the subsidiary to the extent that their payment was recommended by counsel for the Trustees (R. 83).

The Tort Creditors' Committee and the City of Pittsburgh appealed to the Circuit Court of Appeals for the Third Circuit from such portion of the order as directed the payment of underliers' taxes (R. 86, 87).

On April 30, 1940, the Circuit Court of Appeals, after hearing, reversed the District Court, in an opinion written by Albert B. Maris, C. J., and held that the debtor's Trustees were not liable for the underliers' taxes (R. 104 to 110). It was the opinion of the Circuit Court that the obligation of the debtor to pay the taxes was an additional consideration for the use of the underliers' property and was, therefore, a rental obligation and not a tax liability. The Circuit Court refused to adopt the view that the separate corporate entities of the underliers should be disregarded; the underliers had refrained from filing petitions for reorganization and were not subject to the jurisdiction of the Court. The Circuit Court was of the opinion that the Trustees, until the affirmation of the leases and operating agreements, had as their sole obligation the duty to pay lessors a reasonable amount for use and occupation, which amount could not be in excess of the net earnings derived from the operation of the lessors' properties. The Court held that before any payment could be made it would be first necessary for the Court to determine the property which was being used, the extent of its use, and the net earnings being derived therefrom or its value.

Petitions for writs of certiorari were filed by the Philadelphia Company and certain of the underliers on June 15, 1940, and writs of certiorari were granted on October 14, 1940 (R. 115).

IV.

SUMMARY OF ARGUMENT.

The problem involved in the case at bar is not a tax problem. The debtor's sole liability for the taxes of the underliers arises out of its covenants in the leases with the underliers wherein the debtor assumed and agreed to pay as part of the consideration under the agreements all the taxes of the underliers. The obligation imposed upon the debtor by such covenants is not a tax obligation but a mere contractual obligation. Inasmuch as the debtor's obligation is merely contractual, the liability of the Trustees for the underliers' taxes is of no higher dignity and status. With respect to taxes of the underliers which accrued subsequent to the filing of the petition for reorganization, the Trustees have the same duty as to their payment as they have for any other obligation under their debtor's executory contracts. With respect to taxes of the underliers which accrued prior to the filing of the petition, the underliers have only an unsecured general contract claim arising from the debtor's failure to pay the taxes.

The Act of Congress of June 18, 1934, 48 Stat. 993 (28 U. S. C. A. Sec. 124a), which provides that any trustee appointed by any United States Court, who is authorized by said Court to conduct any business, shall be subject to all State and local taxes applicable to such business, did not convert the Trustees' obligation under the leases with respect to the underliers' taxes into a tax obligation. Section 124a imposes upon the Trustees no greater tax obligation than would be imposed on the debtor if not in reorganization. The Trustees are not operating the businesses of the underliers (which underliers are not in reorganization) but are merely utilizing their properties in the operation of the debtor's business

to the same extent that the debtor used the underliers' properties prior to reorganization. A construction of Section 124a which limits the Trustees' obligation to the precise limits of the debtor's obligation prior to reorganization, will not deprive petitioners of their property without due process of law contrary to the Fifth Amendment of the Constitution. The inability of the underliers to have their taxes paid is the result of their own conduct. The adoption of petitioners' construction may materially injure respondents by reducing the funds available for the payment of unsecured creditors.

There is neither authority nor sound reason for holding that it is the duty of receivers or trustees to pay the taxes of lessor companies, which are not in reorganization, merely because the Trustees are using the properties of the underliers in connection with the operation of the debtor's business.

The Trustees' obligation to pay the taxes of the underliers which accrued after the filing of the petition for reorganization is governed by the rules with respect to executory contracts. The Trustees are only liable, pending affirmance or disaffirmance of the leases and operating agreements, for use and occupancy of the properties of the underliers, which in the case of railways is measured by net earnings. No evidence was adduced as to the extent of the net earnings. Consequently, the underliers are not entitled at this time upon the present record to an order directing the Trustees to pay the taxes of the underliers or to advance any funds until their respective net earnings are established.

V.

ARGUMENT.

It is not often that a holding company blandly asserts that its intricate intercorporate structure should be ignored, and insists that when the debtor company took possession of the properties of the underliers "the underliers became a mere corporate shell." (Petitioner's Brief, p. 12). Such bold assaults upon the integrity of the separate legal entities of the underliers are usually made by disgruntled creditors and intransigeant taxpayers.

In the case at bar, however, it is the grandparent holding company* which impugns the sanctity of the separate corporate entities of the fifty-five underlier companies and urges this Court to hold that taxes assessed against the fifty-five underliers should be paid by the debtor corporation, the Pittsburgh Railways Company. And it is the general unsecured creditors who are insistent that the underlier corporations which have been kept intact and carefully nurtured for several decades, the securities of many of which are publicly owned, be compelled to retain their separate corporate existences and concomitant responsibilities.

The taxes which are involved in the instant case were levied and assessed against the various *underlying companies* and not against the Pittsburgh Railways

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* The Philadelphia Company owns all the stock of the Pittsburgh Railways Company, which in turn has an investment of $32,000,000.00 in the stock of the underliers (R. 106). The Philadelphia Company owns directly or indirectly the stock of thirty-eight of the underliers (R. 17, 18). The rest of the underliers are owned by outside interests.

Company, debtor in reorganization. These taxes, amounting to $285,203.93, were levied upon the capital stock, corporate loans and incomes of the lessor underlying companies by the Federal and State authorities.

The lease and operating agreements governing the underliers' properties in the possession of the Pittsburgh Railways Company contain clauses whereby the lessee Railways Company agreed to pay, in addition to the rent and other charges, all Federal, State and municipal taxes assessed against the lessor or which by any future law or by contract the lessor may be required to pay (R. 7). The lease and operating agreements have been neither affirmed nor disaffirmed by the Trustees of the debtor in reorganization (R. 62). While the properties of the underliers are in the possession of the Trustees for the Pittsburgh Railways Company and are being used and operated by the Trustees together with the properties of the debtor, none of the underlying companies has submitted itself to reorganization with the debtor (R. 66).

It was the position of the Trustees of the Pittsburgh Railways Company and is the position of the Philadelphia Company, Petitioner, which owns all of the stock of the debtor, that the Court should ignore the separate corporate identities of the debtor and its fifty-five underlying companies and treat them all as one unified transportation system. It is urged that the taxes of the underlying companies are in practical effect the taxes of the unified system and should, therefore, be paid as administrative expenses by the Trustees of the debtor in reorganization.

It is earnestly submitted that this proposition is wholly untenable. It negatives the legal effect of the separate corporate structures of the underliers and ignores the salient fact that none of these taxes was

assessed or levied against the debtor in reorganization. Its adoption would inevitably operate to the advantage of the holding company and the underliers, and to the impairment of the rights of creditors of the debtor in reorganization.

I. There Is No Tax Liability Upon the Trustees of the Lessee Debtor by Virtue of the Lease and Operating Agreements With the Underliers.

The taxes in question* fall naturally into two broad classifications:

1. Taxes assessed against the underliers since the commencement of the reorganization proceedings, totaling $153,302.19.

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* Unpaid balances of Federal income taxes for the year 1937, payments due June 15, September 15, and December 15, 1938 .. $ 97,412.14
Federal income taxes for the year 1937 withheld at source in respect to interest upon obligations of underliers, payment due June 15, 1938 ..... 6,850.01
Pennsylvania corporate net income taxes for the year 1937, payment due May 15, 1938 ..... 27,639.59
Federal income taxes for the year 1938 .... 50,501.26
Federal income taxes for the year 1938, withheld at source with respect to interest upon obligations of underliers 2,668.08
Pennsylvania corporate net income taxes for the year 1938 ..... 18,335.72
Pennsylvania capital stock taxes for the year 1938 ..... 64,294.57
Pennsylvania corporate loans taxes for the year 1938 in respect to interest upon the obligations of underliers 17,502.56

Total $285,203.93

2. Taxes assessed against the underliers prior to the commencement of the reorganization proceedings, totaling $131,901.74.

1. *Taxes Which Accrued Subsequent to Reorganization.*

Certain of the taxes involved in this proceeding admittedly accrued *after* the filing of the debtor's petition for reorganization. The taxes falling within this category are the Federal Income taxes of underliers for 1938, Federal Income taxes for 1938 withheld at source with respect to obligations of underliers, Pennsylvania Capital Stock taxes of underliers for 1938, Pennsylvania Corporate Loans taxes of underliers for 1938, and Pennsylvania Corporate Net Income taxes of underliers for 1938 (R. 6 to 20).

All of these taxes were levied and assessed against the various underlying companies and not against the Pittsburgh Railways Company, the debtor in reorganization. None of the underlying companies is in reorganization, nor do the taxes bear any relation to the properties leased by the underliers to the debtor (R. 67).

It is respectfully submitted that cogent reasons must be advanced for imposing upon the Trustees of a debtor lessee the tax obligations, not of the debtor lessee, but of fifty-five underlying companies having separate corporate structures from 1902 to the present time. It is earnestly submitted that an examination of the arguments advanced by counsel for petitioners to buttress the claim for payment by the Trustees of the underliers' taxes assessed after the institution of the reorganization proceedings, prove them to be unsupported by either sound reasoning or reported judicial thinking.

The liability of the Trustees of the debtor company for the taxes of the underliers depends entirely upon the

nature of the debtor's obligation for such taxes. The sole source of the debtor's liability for the underliers' taxes is found in the lease and operating agreements between the Pittsburgh Railways Company and the underliers, which require the Pittsburgh Railways Company to pay in addition to all expenses of operation and ordinary maintenance, all taxes assessed against the underliers, or which by future law or by contract the lessor underliers may be required to pay (R. 7).

The Pittsburgh Railways Company by these covenants did not become liable for the taxes of the underliers as a taxpayer; the obligation assumed thereby was purely a contractual one. The taxes continued to be levied and assessed against the underliers, and the Pittsburgh Railways Company paid them in addition to rent and other payments required by the lease and operating agreements.

The distinction between the tax obligation of the debtor and its obligation with respect to taxes of the underliers assumed by it as lessee under the lease agreements is real and of controlling importance in analyzing the issues presented by the case at bar. For if the debtor's covenant to pay the underliers' taxes is a contract and not a tax obligation, then it follows that the obligation of the debtor's Trustees is likewise not a tax obligation.

The validity of the distinction here made was fully recognized by the Court below. We quote from the opinion of the Hon. Albert B. Maris, C. J., in the case at bar, 111 Fed. (2d) 932, at p. 933 (R. 105):

> "The sole obligation of the debtor with respect to these taxes arose under the leases and operating agreements with the underliers which provided that the debtor should pay all taxes assessed against the underliers. The obligation of the debtor to pay the

taxes was an additional consideration for its use of the underliers' property, and, therefore, as to it a rental obligation rather than a tax liability."

In *Hardeman v. Hendrix,* 29 F. (2d) 738 (C. C. A. 5th Circuit, 1928), a similar conclusion was reached. There the bankrupt leased property at a stipulated rental and agreed to pay all taxes and assessments against the property. The Court held the bankrupt's obligation was not a tax obligation. We quote from the Opinion of the Court at page 739:

> "The bankrupt agreed to pay both the taxes and the sidewalk assessment as a part of the rent and his failure to do so was no more than a breach of contract. The balance due by the bankrupt is for rent, and doubtless constitutes a provable claim, but it cannot be given the priority that attaches to taxes due and owing by a bankrupt on his property."

Even where the taxes assumed by the lessee were real estate taxes assessed against the very properties leased, the obligation was held not to be a tax obligation.

In *Philadelphia and Reading Coal & Iron Co. v. Van Deusen,* 103 F. (2d) 869 (C. C. A. 3d. Cir. 1939, certiorari denied October 9, 1939, 84 L. Ed. 77), where the debtor coal mining company had agreed to pay the taxes assessed against the leased properties, the claim of the lessor was declared to be an unsecured claim and not a tax claim. We quote from the Opinion of the Court at p. 871:

> "The taxes levied from time to time upon the real estate were not shown to bear any relation to the value either of the coal actually removed or of the building sites actually demised. In the absence of such evidence the court properly declined to allow the claim for the sums paid in taxes as in the

nature of payments for use and occupation. Since the taxes as such had been paid the taxing authorities had no further interest in the matter. *Nor was it ever a tax obligation of the debtor.* Hardeman et al. v. Hendrix (C. C. A., 5th Cir.), 13 Am. B. R. (N. S.) 314, 29 F. (2d) 738. The appellants have a general unsecured claim under the agreement against the debtor for repayment of the taxes, which is postponed to all claims having priority. The District Court did not err in disallowing this claim." (Italics ours)

A similar conclusion was reached by the Circuit Court of Appeals for the Second Circuit in the case of *American Brake Shoe Foundry Company v. New York Railways Company,* 282 Fed. 523.

The case of *In re Brown,* 123 Fed. 639 (D. C., W. D. N. Y., 1903), is consonant with established authority, and holds that the lessors of the debtor bankrupt have no more than a contract claim for the taxes the bankrupt has failed to pay under the lease.

From the principles enunciated in the foregoing cases, it is clear that the debtor's obligation by virtue of the covenants in the leases with the underliers in the case at bar is not a tax obligation, but a contract obligation. It might as logically be argued that in the absence of the covenant to pay taxes, such as is contained in the lease agreements here involved, proof that part of the rental was used by the underliers to pay taxes would render the Trustees of the debtor in reorganization liable for the payment of such taxes. The conclusion is ineluctable that the obligation of the Trustees of the debtor under these leases is no greater than that of the debtor. The underlying lessor companies have, therefore, by virtue of the lease covenants, nothing more than a general contract claim and not a tax claim payable by the Trustees as an administrative expense.

2. *Taxes Which Accrued Prior To Reorganization But Which Were Payable Thereafter.*

It is submitted, moreover, that the debtor Railway Company has a contractual and not a tax obligation for the taxes which became due *prior* to the commencement of the reorganization proceedings. (See Schedule of taxes, p. 11 of this Brief.) The failure of the debtor to pay these taxes was a breach of the lease and operating agreements, and the amounts thereupon became due as contract claims against the debtor in reorganization and are not tax liabilities payable by the trustees of the debtor as an administrative expense.

The specific taxes falling within this category are:

A. Federal Income taxes assessed against the underliers for the year 1937, which accrued on January 1, 1938 and became due March 15, 1938. (R. 60, Revenue Act of 1936, Sec. 53 (a) 1, 26 U. S. C. A. Sec. 53 (a) 1.) This was prior to May 10, 1938, the date of the filing of the petition for reorganization. These taxes could by law be paid in quarterly installments.

B. Federal Income taxes for 1937, withheld at source, in respect to interest upon the obligation of underliers, (R. 59, Act of May 10, 1934, c. 287, Sec. 143 (c), 26 U. S. C. A. Sec. 143 (c).) These taxes accrued January 1, 1938 and became due on March 15, 1938, prior to the filing of the petition for reorganization, although payable any time prior to June 15, 1938.

C. Pennsylvania Corporate Net Income taxes assessed against the underliers for the year 1937. (R. 85, Pa. Act of May 16, 1935, P. L. 208, as amended, 72 Purd. Stat. Sec. 3420 (d).) These taxes accrued January 1, 1938 and became due April 15, 1938, prior to the date of

the filing of the petition for reorganization, although payable any time prior to May 15, 1938.

It appears to be well settled that the controlling date for determining when an obligation is due and owing for bankruptcy purposes is the time of accrual of the obligation to pay the tax rather than the time when the tax obligation is to be discharged by payment:

New Jersey v. Anderson, 203 U. S. 483 (1906);
In re International Match Corp., 79 F. 2d, 203, 205 (C. C. A. 2d 1935), certiorari denied sub nom. Delaware v. Irving Trust Co., Trustee, 296 U. S. 652 (1935).

Since the authorities hereinbefore adverted to (this Brief p. 14 *et seq.*) clearly state that the lessee has no tax obligation for taxes payable by virtue of the covenants in the leases with the lessors, the same principle can be invoked with even greater force with respect to taxes that accrued prior to the commencement of reorganization proceedings but that were payable thereafter.

It is, therefore, respectfully submitted that with respect to taxes, which accrued prior to the reorganization proceedings, the underliers are in the same position as general creditors and under no accepted legal theory can their claims be converted into preferred tax claims. As was succinctly stated by the Hon. Albert B. Maris, Circuit Judge, in the Opinion written by the Circuit Court in the case at bar, reported at 111 F. (2d) at p. 932 (R. 107):

> "Even though the taxpayer was given the option to pay these taxes in installments the taxes were actually due on the dates mentioned, which were the dates fixed by law for filing the tax returns. The failure of the debtor to pay these taxes was a

breach of the leases and operating agreements and the amounts then due became simple contract claims against the debtor, due when the debtor's petition was filed. As to these claims the underliers must take their position with all other general creditors."

It thus appears that whether the taxes of the underliers accrued prior or subsequent to reorganization they are not tax obligations of either the debtor or the Trustees of the debtor in reorganization by virtue of the covenants contained in the lease and operating agreements.

II. The Act of June 18, 1934, 48 Stat. 993 (28 U. S. C. A. Sec. 124a) Does Not Require the Trustees of the Lessor to Pay State Taxes Assessed Against Underliers.

The Trustees appointed in the case at bar for the debtor Railways Company were authorized by the Court to—

> "preserve, maintain, manage and operate and keep in good order, condition and repair, the property and estate in possession of and/or owned by the Debtor, and to manage and conduct its business; and without limiting the generality of the foregoing, to collect and receive the income, rents, revenues, tolls, issues and profits of said property and estate; * * *"

and

> "to pay all taxes and assessments due or to become due upon the property in possession of and/or owned by the Debtor; * * *". (R. 6).

Under authority of this order the Trustees have been operating the business of the debtor company, and in connection therewith are utilizing the properties of the underliers embraced in the lease and operating agreements.

It is urged by Petitioners that the provisions of the Act of June 18, 1934, 48 Stat. 993 (28 U. S. C. A., Sec. 124a), impose upon the Trustees the duty to pay all State and local taxes assessed against the underliers. The basis for this contention is found in the fact that the Trustees have been operating the debtor's business, utilizing the properties of the underliers covered by the leases, under an order of Court.

It is submitted that the interpretation sought by Petitioners to be imposed upon this Section is disconsonant with the provisions of the Statute and finds no support in judicial authority. Section 124a provides as follows:

> "Any receiver, liquidator, referee, trustee, or other officers or agents appointed by any United States court who is authorized by said court to conduct any business, or who does conduct any business, shall, from and after June 18, 1934, be subject to all State and local taxes applicable to such business the same as if such business were conducted by an individual or corporation: * * *"

This statute was enacted in recognition of the fact that business, whether in receivership or not, should pay the price for the protection and security afforded it by government.

The natural interpretation of the language of the Act is to impose upon the Trustees the same responsi-

bility as to taxes that the debtor had prior to the commencement of reorganization proceedings. Such was the clear intention of Congress in enacting this legislation.* Since the debtor's obligation for the state taxes of the underliers was a contractual and not a tax obligation, it follows that the Trustees' obligation is likewise not a tax obligation, and that it is not converted into a tax obligation by the provisions of Section 124a. Section 124a does not purport to impose a heavier tax obligation upon the Trustees than the debtor would have if no reorganization proceeding were pending, but only to maintain the same liability.

The District Court seemingly gave great weight to the argument of both the Trustees of the debtor and the

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* The interpretation placed by respondents upon Section 124a is borne out by the Report of the House Committee on the Judiciary, House Report No. 1138 of the 73d Congress, 2nd Session, on the Act when pending in Congress. The report states:

"The purpose of this bill is to subject businesses conducted under receivership in Federal Court to State and local taxation the same as if such businesses were being conducted by private individuals or corporations.

"The United States District Court for the Western District of Missouri in the case of *Howe v. Atlantic, Pacific & Gulf Oil Co. et al. (State of Missouri et al., Intervenors)* (4 Fed. Supp. 162) recently held that a receiver operating a gasoline-and-oil distributing business under appointment by the Federal Court was not liable for a sales tax on motor fuel levied by the State of Missouri. As a consequence of this decision, your committee is advised, the State of Missouri and other States having similar Statutes are losing thousands of dollars of revenue per month.

"No good reason is perceived why a receiver should be permitted to operate under such an advantage as against his competitors not in receivership, and the States and local governments be deprived of this revenue."

Philadelphia Company, holder of all its stock, that the integration of the system necessitated and justified the payment by the Trustees of the debtor of the taxes of the underliers. In doing so it completely disregarded the Master's Report which recommended a contrary order (R. 72). Watson B. Adair, Master, made this specific finding with respect to the taxes of the underliers (R. 67):

"Taxes on Underliers.

24. It is uncertain that any of the leases or operating agreements will ever be accepted by the trustees. Unless they be accepted, their covenants for payment of taxes will not bind the estate to pay the taxes of the underlying companies as administration expenses. There is no showing that the amounts, if any, owing to the respective companies for the net earnings of their properties or for the use of their properties by the trustees are proportionate to their taxes or even that in every case they are as much as their taxes. Payments of taxes regarded as payments for such earnings or use might give some companies a greater proportion of their dues than others and might even overpay some. If the debtor's claims (paragraph 17) against some of the underlying companies be meritorious, they may affect the equities. There does not appear to be any exigency which might justify the risk of effecting preferences or overpayments. It does not seem practicable to deal with the underliers' taxes in the mass, or to dispose of them separately upon the facts shown. At present the taxes of the underliers should not be paid by the trustees."

No case was cited by the District Court which in fact supports the extraordinary doctrine enunciated by it that the debtor's Trustees are responsible for the taxes

of underliers. The cases cited by the Court and which are relied upon by the Petitioners herein are all cases where the petitioners now frankly concede the *taxes were assessed and levied against the debtors in bankruptcy and not against their lessors* (Petitioner's Brief, p. 16).

In reaching its result the District Court not only ignored the fact that Section 124a imposes upon the Trustees the same tax liability as the debtor itself would have if not in reorganization, but gave a highly strained interpretation to the word "business" as used in the Statute when it construed the word "business" to include not only the business of the debtor but also the businesses of the underliers. Section 124a makes the Trustees liable only for such State and local taxes as are applicable to the business being conducted by the Trustees. The Trustees admittedly have not been authorized to conduct and are not conducting the separate businesses of the underliers. They have been operating the business of the debtor, using in their operation the properties of the underliers to the same extent as and to no greater extent than the underliers' properties were used by the debtor prior to reorganization. The taxes assessed against the underliers are, therefore, not applicable to the business being operated by the Trustees.

The District Court's construction of the word "business" ignores the fact that the Trustees were appointed for the debtor to operate the debtor's business, and brings into consideration a fictitious personality — the entire transportation system—having no legal existence and without responsibility. The acceptance of this construction fails to take into consideration that, while the properties of the underliers are in the possession of the Court through its Trustees, the underliers themselves are not in reorganization and are not under the control

and direction of the Court. Moreover, the very taxes sought to be paid arise solely by reason of the existence of the separate corporate entities of the underliers and bear no relation to their properties being used by the Trustees or to the value of the properties to the Trustees.

It is submitted that the only business being conducted by the Trustees is that of the debtor, and the taxes of the underliers are applicable to that business only if the debtor's liability for such taxes is a tax obligation. As shown hereinbefore the debtor's obligation for the underliers' taxes is only a contractual obligation.

The most recent judicial pronouncement on this phase of the case at bar appears in the case of *Webster and Atlas National Bank of Boston v. Palmer et al.*, 111 F. (2d) 215, decided April 16, 1940, certiorari allowed October 14, 1940, No. 120 October Term, 1940.

The petitioners in the case at bar considered the *Webster and Atlas case* to be so identical with the instant case both as to the facts and as to the law applicable thereto, that it was referred to, relied upon and quoted at length in support of the petitions for certiorari to your Honorable Court. (Petition for Certiorari, page 7).

Even if the decision of the Second Circuit in that case should be sustained by your Honorable Court, it is respectfully submitted that such a conclusion would not of necessity rule the case at bar. The facts in the case of *Webster and Atlas National Bank of Boston v. Palmer et al., supra,* and in the instant case are patently dissimilar and the principles to be deduced from these cases are accordingly so unlike that the decisions in the two Circuits could both stand without destroying the pattern of judicial concepts.

The following fact situation was before the Court in the *Webster and Atlas National Bank of Boston v. Palmer* case:

The Trustees of the New York, New Haven and Hartford Railroad Company, debtor in reorganization under Section 77 of the Bankruptcy Act, were using in connection with their operation of the debtor's business, the properties of two lessors. When the lessors' lines were found to be unprofitable to the debtor, the Trustees were permitted to reject the leases. Since as a practical matter the lessors were unable to operate their own properties, the Court was forced, in the public interest, to direct the Trustees, pursuant to Section 77 (c) (6) of the Bankruptcy Act, *to continue the operation of the rejected lines for and on account of the lessors.*

Thereafter, the Trustees of the New Haven, asserting that the rejected leased lines were being operated unprofitably, and that the continued diversion of the New Haven funds to meet the expenses of operating the lessors' lines would prejudice the creditors of the New Haven Railroad Company, petitioned the District Court for authority to withhold payment of the lessors' taxes. The District Court thereupon directed the withholding of payment. The Circuit Court of Appeals for the Second Circuit reversed this order on the ground that the Act of June 18, 1934, 48 Stat. 993 (28 U. S. C. A., Sec. 124a) required the Trustees of the New Haven to pay the lessors' taxes so long as they operated the lessors' lines.

There are real and controlling distinctions between the facts of that case and the fact situation obtaining in the case at bar:

1. In the case at bar the Trustees, while using in connection with the operation of the debtor's business

certain properties of the underlying lessors, have neither rejected nor affirmed the lease and operating agreements with the underlying lessors.

In the *Webster and Atlas National Bank of Boston v. Palmer* case the lease agreements were specifically rejected by the Trustees pursuant to Court order.

2. In the case at bar the properties of the lessors are being operated by the Trustees of the debtor lessee incidental to, in connection with and as part of the operation of the debtor's business, and *not as separate businesses for or on account of the lessors.*

In the *Webster and Atlas National Bank of Boston v. Palmer* case the operation by the Trustees of the lessee of the properties of the lessors was specifically separated from the operation of the debtor's properties and business and was by Court order *operated as separate businesses for and on account of the lessors.*

It is noteworthy, moreover, that the *Webster and Atlas* decision is based upon a construction of Section 77 (c) (6) relating to interstate railroads, which has no counterpart in Chapter X of the Chandler Act or in Section 77B, which it replaced. Section 77 (c) (6) specifically empowered the Court to order the Trustees, after the rejection of the leases, to operate the lines for and on behalf of the lessors. No such order was made in the instant case, nor have the leases been rejected.

It is thus patent that there are vital and controlling distinctions in the two cases that require the application of entirely different principles of law.

Seemingly, petitioners themselves realize the inapplication of the *Webster and Atlas National Bank of Boston v. Palmer* decision, for despite the great stress placed

upon the decision in the brief supporting the petition for certiorari, the brief now before your Court, filed by the Petitioners, contains only a passing and casual reference to the case and nowhere discusses either its facts or the legal principles deducible therefrom. (See Petitioners' Brief, p. 27.)

Section 124a does not impose greater tax obligations upon the Trustees than was imposed by law upon the debtor prior to reorganization. Since the debtor's obligation under its leases for the payment of taxes of its lessors was not a tax obligation under the authorities hereinbefore discussed, what basis is there for holding that Section 124a makes the Trustees liable as taxpayers for the taxes of the underliers? It is submitted that there is no tenable basis for this conclusion, for the properties of the underliers being utilized by the Trustees in connection with the operation of the debtor's business are identical in character and extent of use with those used by the debtor in its operation prior to reorganization.

It is earnestly submitted, therefore, that Section 124a by its express language renders the Trustees of the debtor in reorganization responsible only for the taxes of the business being operated by them—the taxes of the debtor—and does not render the Trustees liable for the taxes of the underliers, for which taxes, as such, the debtor is not liable.

Section 124a Does Not Violate the Fifth Amendment to the Constitution.

Petitioners further contend that unless their interpretation of Section 124a is adopted, the section is unconstitutional because it deprives the underliers of their property without due process of law in violation of the

Fifth Amendment of the Constitution of the United States (Petitioners' Brief, p. 14). It is submitted that a construction of Section 124a, which limits the tax obligation of the Trustees to the same tax obligation as the debtor itself would have if not in reorganization, does not deprive the underliers of their property without due process of law. If the taxes, penalties and interest become liens upon the properties of the underliers, it is not by virtue of the Congressional statute or the interpretation thereof by the courts; they become so by virtue of the acts of the underliers themselves who have permitted their earnings to become commingled with those of the debtor, and for reasons advantageous to petitioners, consented to a system of bookkeeping which makes it difficult to ascertain the net earnings of the underliers. Respondents are not opposed to the payment of the underliers' taxes if the underliers establish their respective net earnings during the period of administration by the Trustees. To require the underliers to prove their claims by establishing their net earnings, as does the decision of the Circuit Court of Appeals, does not result in depriving them of their property without due process of law. It is an elementary legal principle that he who asserts a claim must prove it. The denial of a claim because of lack of proof does not deny due process to the claimant.

Nor does the fact that certain of the debtor's taxes are to be paid while the underliers taxes are not being paid deprive petitioners of their property without due process of law. The debtor's taxes stand upon an entirely different footing. The debtor's taxes are clearly a tax obligation, and as such, are entitled to payment in priority over other administration expenses, such as use and occupancy payments. This is well brought out in the Report of the Special Master, who stated as follows (R. 65):

"20. There is authority for the doctrine that taxes are entitled to priority over other administration expenses: Atkinson & Co. v. Alrich-Clisbee Co. (D. C. Mass. Morton J.) 248 Fed. 134; Piedmont Corp. v. Gainesville & N. W. R. Co. (Dis. Ct. Ga. Sibley J.) 30 F. (2d) 525; Coy v. Title Guarantee & Trust Company (C. C. A. 9th) 220 F. 90; Union Trust Co. v. Illinois M. R. Co. 117 U. S. 434, 481, 29 L. Ed. 963, 979. Whether or not that be so generally, in the present case it appears equitable that they be given priority over the possible claims of trackage owners for the use of the properties.

21. It is the duty of a common carrier to furnish and operate 'a reasonably sufficient number of safe facilities, and run and operate the same with such motive power as may reasonably be required, in the transportation of all such passengers or property as may seek, or be offered to it, for such transportation * * *': Pennsylvania Act of May 28, 1937 P. L. 1053, Section 403, Purd. Pa. Digest, Title 66 Section 1173. This duty of the underlying companies which own the tracks and franchises has been performed by Pittsburgh Railways Company or its receivers or trustees since 1902. The underlying owner companies are not presently prepared to resume the performance of their duty to the public. Even if they had the necessary capital, cars and personnel, their several properties have for a generation been operated as a unit and by force of circumstances the operation of many of them has become dependent upon the operation of others of them. It can hardly be doubted that the separate operation of many of the properties of the several owners would be impracticable. Although the underlying companies themselves are not in bankruptcy or reorganization, their properties in reality are in reorganization to the extent that they

are in the possession of the trustees, will probably be involved somehow in the reorganization of Pittsburgh Railways Company if any reorganization is effected, and are being operated. That operation appears to be as much for the benefit of the owner companies and their creditors as for the benefit of Pittsburgh Railways Company and its creditors. To the extent that the operation proves profitable, the underliers can be paid something for the use of their properties, probably more than they would have earned separately. Should the profits prove inadequate and the administration be insolvent, there will be nothing for the stockholders and creditors of Pittsburgh Railways Company, except in so far as those creditors have a lien on a minor part of the mileage, but the operation of the system will have preserved or tended to preserve the properties of the owner companies. The operation and management of the properties being for the common benefit, the current expenses thereof should be paid currently even though there ultimately may not be enough to pay the potential separate claims of the owner companies for compensation for the use of their properties."

Petitioners' argument in this respect overlooks the salient fact that the operation of the underliers' properties by the Trustees is just as much for the benefit of the underliers as it is for the benefit of the debtor. *In the Matter of Connecticut Company,* 95 F. (2d) 311. In order to preserve the underliers' franchises, their respective properties must be operated. None of the underliers has any equipment or other facilities with which to operate its lines. They have not demanded the return of their properties. They well know that they would be in a position where they would have no properties whatsoever because their franchises have lapsed because of discontinuance of service.

The construction contended for by petitioners would, however, deprive *respondents* of *their* property without due process of law. To permit the payment of the underliers' taxes as a tax obligation would impose upon respondents, unsecured creditors of the debtor, the burden of paying the taxes of the underliers to the extent that the net earnings of each underlier was insufficient to meet its taxes—a burden which should be borne by the underliers. Funds which should go to the creditors for their claims will be invaded to pay the taxes of the underliers.

III. Where the Underlier Companies Have Maintained Their Separate Corporate Structures for Thirty-eight Years, Their Identities Will Not Be Erased for the Benefit of the Holding Company and the Underliers, to the Detriment of Creditors.

The Trustees of the Pittsburgh Railways Company, the debtor in reorganization, recommended the payment of all taxes as an administration expense, even though none of them was, assessed against the debtor and despite the fact that the underliers were not in reorganization (R. 93). The Philadelphia Company, holding company of the debtor, and certain of the underliers claimed that aside from any obligation to pay these taxes that arose under the lease and operating agreements, as a matter of general law all taxes, Federal as well as State, should be paid as an administration expense, because of the fact that the debtor and underlying companies have been operated as a single unified transportation system. They adopted the Trustees' contention that:

> "Whatever may be the technical legal relationship existing between Pittsburgh Railways Company and its underlying street railway and incline plane companies, in point of fact and for all prac-

tical purposes all those companies have been operated as a single and unified transportation system since 1902, and they are now being operated as such by the Trustees of Pittsburgh Railways Company, debtor. The operation of the business of the several companies as a unified system was brought about by the voluntary action of those companies." (R. 93)

It is quite true that since 1902 the street railway system in Pittsburgh has been owned by more than fifty companies, operating under a cumbersome holding company structure as a unified transportation system. It would appear that the retention of the "technical legal relationship" had certain measurable advantages, since not even the receivership of 1918-24 resulted in the elimination of all the underlier companies. It is noteworthy that the underliers have not voluntarily submitted themselves to the jurisdiction of the Court in the present reorganization and are not presently under the supervision, control or direction of the Court.

The Philadelphia Company, holder of all the stock of the Pittsburgh Railways Company, has not always been so ready to ignore the technicality of the relationship between itself and the debtor and the fifty-five underliers. For the purpose of escaping liability on underliers' bonds and avoiding payment of municipal liens, they have clung tenaciously to the legal concept of separate corporations. Judge Maris, in delivering the Opinion of the Circuit Court in the case at bar, states at page 933 (R. 106):

"The appellees argue that since the properties of the underlying companies are in the possession of the trustees of the debtor and are being used and operated by them with properties of the debtor as a unified system the taxes of the underlying companies are, in effect, taxes of the unified system and

are, therefore, operating and administrative expenses of the trustees.[3] The district court adopted this view.

We are asked to ignore the legal relationships existing between the Philadelphia Company,[4] the debtor and the underliers[5] and their separate corporate identities and treat them all as one unified transportation system. For all practical purposes, the appellees argue, the separate identity of the underlying corporations has been lost. We are not impressed with the equity of this plea. Under other circumstances the appellee, the Philadelphia Company, has not sought to ignore its corporate identity but has taken refuge behind it to escape liability upon an underlier's bond,[6] as has also the debtor[7]

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[3]The trustees state:

'We do not contend these taxes are payable because the debtor contracted to pay them. While such contracts exist, thus far the Trustees have not affirmed them and may never do so. Whatever might be the effect of affirmance of the operating agreements and leases on the obligation of the Trustees to the underliers, we submit that the obligation of the Trustees to the taxing authorities is not governed by those contracts or by any action that might be taken by the Trustees with respect to them. Nor do we contend these taxes are payable as compensation for use and occupancy of the underliers' properties by the Trustees.'

[4] The Philadelphia Company is the holding company which owns all the stock of the debtor.

[5] The debtor has an investment of approximately $32,000,000 in the stock of the underliers.

[6] *Allen v. Philadelphia Co.*, 265 F. 807, affirmed 265 F. 817. *Cf. Ambridge Borough v. Philadelphia Co.*, 283 Pa. 5, 129 A. 67.

[7] *Sec. Ave. T. Co. v. U. T. Co. of PBG.*, 328 Pa. 257, 195 A. 25.

and an underlier.[8] The appellees, the Philadelphia Company and the underliers, appear not too sincere in their contention that the corporate form is merely fiction when it is observed that the underliers have refrained from themselves filing petitions for reorganization, with the result that the only corporations in the system which are in process of reorganization are the debtor and its subsidiary. The Trustees are not trustees for the Philadelphia Company nor for any of the underliers. Neither the past history of the system nor the present state of the reorganization proceedings would, we think, justify our ignoring the existence of the separate legal entities which compose that system."

It is earnestly submitted that corporate capacity is a legal fact, not a fiction. The corporate separation in the case at bar, though purely formal, was none the less a reality for thirty-eight years.

Where adherence to the distinct or separate existence of corporations would sanction a fraud or result in the evasion of the law or other injustice, courts have not hesitated to disregard the entity concept. But those well recognized variations in the pattern of judicial thinking afford no basis for the plea of a holding company that its carefully cumbersome underlying system should be merged, momentarily, for the sole purpose of paying the underliers' taxes from the assets of the debtor, to the impairment of rights of creditors.

While the dominant consideration in the reorganization proceeding is, as argued by petitioners, the development and consummation of a plan of reorganization, it is respectfully submitted that to disregard the corporate entities of the underliers will in no way facilitate the

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[8] *Lyon v. Pitts. A. & M. Tr. Co.*, 312 Pa. 584, 169 A. 229."

development of a plan of reorganization. The plan of reorganization contemplated by the Trustees envisages a single new company which will acquire title not only to the properties of the debtor but also to those of the underliers (R. 93). This means the rejection of the leases. One of the key problems in the proceedings will be the question of the allocation of the securities of the new company among the security holders of the underliers. This will require ascertainment of the value of the several properties of the respective underliers and the evaluation of the respective components of the system. In distributing the securities the Trustees will first have to clear up some of the chaos which permeates the entire proceeding. The amount of the taxes now owed by the underliers will necessarily reduce the purchase price to the new company. To ignore the corporate entities of the underliers at this time will only add more chaos to the existing unsatisfactory state of affairs and increase the burden of developing and consummating a plan of reorganization. Sooner or later this onerous problem must be solved; this is an appropriate time to begin untangling the threads.

IV. While the Trustees Are Liable to the Underliers for Use and Occupancy of Their Properties, the Taxes Assessed Against the Underliers Cannot Be Paid as Advances on Use and Occupancy Allowances.

Inasmuch as the debtor's liability for the taxes of its underliers is a contractual obligation under its executory contracts with the underliers, the liability of the Trustees to the underliers for taxes and other payments is governed by the equitable and legal principles established with respect to the liability of Receivers and Trustees under the executory contracts of their debtor. These principles are well summarized in the opinion of

the Circuit Court of Appeals in the statement of Judge Maris at 111 F(2d) 932 (R. 108):

> "The trustees have no obligation to pay the rentals due under the leases, as such, unless and until they affirm the leases and operating contracts. They have a reasonable time within which to affirm or disaffirm. During the interim their sole obligation is to pay the lessors a reasonable amount for the use and occupation of the properties actually in use. This rule, which was originally laid down in railroad receiverships in equity applies to the reorganization of a street railway under Section 77B of the Bankruptcy Act. If an interim payment is made it is ordinarily held that it should not be in an amount in excess of the net earnings derived from the operation of the lessor's properties."

These principles have been established in a long line of cases in this Court and other Federal Courts. *United States Trust Company v. Wabash Railway,* 150 U. S. 287; *Pennsylvania Steel Co. v. New York City Ry. Co.,* 198 Fed. 721 (C. C. A. 2d Cir. 1912); *American Brake Shoe & Foundry Co. v. New York Rys. Co.,* 282 Fed. 523 (C. C. A. 2d Cir. 1922); *Westinghouse Electric & Mfg. Co. v. Brooklyn Rapid Transit Co.,* 6 F(2d) 547 (C. C. A. 2d Cir. 1925); *In re Connecticut Co.,* 95 F(2d) 311 (C. C. A. 2d Cir. 1938), cert. denied sub nom. *Connecticut Railway & Lighting v. Connecticut Co.,* 304 U. S. 571; *Tardy's Smith, Law and Procedure of Receivers,* (Second ed., 1920, Volume I, page 278; *Clark, Foley and Shaw, Adoption and Rejection of Contracts and Leases,* 46 Harv. Law Rev. 111.

Inasmuch as the Trustees' liability to the underliers is limited by the net earnings of each underlier, it follows as a necessary corollary that the net earnings of each of the underliers must be shown before any payments can be made to it. The reason for the rule has been well stated by the Circuit Court of Appeals in

Public Service Commission v. Philadelphia Rapid Transit Company, 82 F(2d) 481 (C. C. A. 3rd Circ., 1935), Judge Davis, speaking for the Court, stated at page 487:

> "As to the allowances for the use and occupation of the properties leased by the Philadelphia Rapid Transit Company from the underliers, we held, and reaffirm our position, that creditors in a bankruptcy proceeding are entitled to know what property was used and occupied and the extent of that use and occupancy before allowances may be made therefor, and this is particularly so in view of the contention that the debtor is paying for property which it does not occupy or use.
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> *The underliers, like any other person in any bankruptcy proceeding, are entitled to be justly and fairly paid for the use and occupancy of their property;* but, like any other person, they should and must show what that property is and that it is occupied *and used.* They occupy the same position as any other person whose property is being used by receivers and trustees in bankruptcy, and like any other person *they cannot expect a court of bankruptcy to make allowances until they show just what property is being used and occupied and the extent thereof.* Until a court knows that, how can any fair and just allowance be made? When these are shown, surely proper allowances will and should be made, but until then, can they in good faith ask or demand allowances, when no step has been taken to supply the court with this information? If any one in the meantime suffers or is inconvenienced the court is sorry, but the fault cannot be charged to it." (Italics ours).

The decision in *Philadelphia & Reading Coal & Iron Company v. Van Deusen,* 103 F(2d) 869 (C. C. A. 3rd Circ.), is to the same effect.

No evidence has been adduced in the case at bar as to the net earnings of the fifty-five underlier lessors whose properties are being utilized by the Trustees of the debtor in reorganization. It has been strenuously urged that due to the fact that since 1902 all the funds realized from the operation of the transportation system, including those derived from the use of the underliers' properties, have been commingled, that there is no data from which the separate earnings of the underliers can be readily compiled. It is, therefore, claimed that the use and occupancy rule should not be invoked in the instant case.

It is indeed an anomalous position for a holding company which has created and carefully maintained a cumbersome intercorporate structure for thirty-eight years, and for the underliers who acquiesced in this arrangement, to now ask to be absolved from proving their claim because of certain difficulties engendered by the system they chose to adopt.

It is significant that the very taxes which it is contended the Trustees should pay because of the integration of the system are only payable because of the existence of the separate corporate structures of the underliers.

No one questions the reality of the difficulties with which lessors are confronted in attempting to prove net earnings of the fifty-five underlying companies for the purpose of establishing proper charges for use and occupancy. The properties of the underlying companies have not been separately operated since 1902. The funds have all been commingled and no separate book-

keeping system kept. However, the situation was created by petitioners and the respondents should not be asked to shoulder the burdens resulting therefrom.

In other cases of commingling the Courts have not removed the burden from the backs of the owners who willfully commingled the funds, but placed upon such commingers the duty of disentangling the chaos thereby created.*

In the case of *Federal Trade Commission v. Thatcher Manufacturing Co.*, 5 F. (2d) 615 (Circuit Ct. of Appeals, 3d Circuit), Judge Wooley, speaking for the Court, stated (p. 621):

> "In effecting the remedy, however, the Commission must meet the situation as the offending corporation has made it * * * Nor do the acts of the offending corporation in commingling the assets of the corporation whose stock it has acquired in violation of the Statute with assets of its own, raise a legal barrier against remedying an evil which the law was expressly enacted to prevent. Just how, in a practical way, this shall be done in the case at bar, the Commission purposely left open by the last paragraph of the order *which directed the respondents to submit a plan to that end.*" (Italics ours).

We are confident that the underliers in the case at bar can and will eventually evolve some appropriate and equitable method of determining the amount of the use and occupancy charges to be paid by the Trustees.

Petitioners urge that because of their inability to show the net earnings of the underliers, the principle

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* *Broom's Legal Maxims* (6th American Edition), p. 212, star p. 275. *Little v. Fleischman*, 98 S. E. 455, p. 458. (N. C. 1919.)

of net earnings is inapplicable in the instant case under the doctrine enunciated in *North Kansas City Bridge & Railroad Co. v. Leness,* 82 F. (2). 9 (C. C. A. 8th, 1936). That case is clearly inapplicable to the present situation. There the leased property was not a railway line but a connecting bridge which was non-revenue producing. Being non-revenue producing property, the Court likened it to other non-revenue producing property such as a depot or terminal which is necessary to the operation of business but which is wholly without revenue-producing capacity. The Court accordingly held that the net earnings rule would not be applicable because the property involved did not produce any revenue. The Court, however, did not hold that it would not be necessary to establish net earnings in the case of revenue-producing properties where the net earnings were difficult of determination only because of the voluntary action of the lessors and lessee of commingling their funds and in failing to keep proper books and records.

The doctrine of the *Leness* case does not support petitioners' contention but strengthens the decision of the Circuit Court of Appeals in the instant case. It requires three things to be done before any payment can be made to or on behalf of the underliers: (1) a classification between revenue and non-revenue producing properties; (2) a determination of the use and occupancy of the non-revenue producing properties; and (3) a determination of the net earnings, if any, of the revenue producing properties. Until these three facts are determined, it is inequitable to pay anything to or on behalf of the underliers in the case at bar.

Finally, petitioners urge that the taxes of the underliers should be paid as they fall due and that the creditors will be protected by an order similar to that entered

in the New York, New Haven and Hartford reorganization, and tacitly approved by this Court in *Warren v. Palmer,* 310 U. S. 132, giving the Trustees a prior lien on the property of an underlier to the extent of the excess of the taxes paid on such property over its net earnings. (Petitioners' Brief, pages 26, 27).

It is respectfully submitted that such an order would not be proper in the present case at this time. The suggestion is here made for the first time. The District Court was not asked to consider such an order and its order directed the payment of the underliers' taxes without providing for any protection for the creditors. Such an order cannot be entered on the present state of the record. No notice has been given to the parties in interest of an intention to ask for a lien. While the underliers themselves may consent to such an order, their bondholders and stockholders have not been heard on the question. The present proceeding arose on a petition for instructions with respect to the taxes and not on a petition for leave to make a loan upon security.

Moreover, there is nothing in the record to show that the security offered is sufficient. There is nothing in the record to show that any particular underlier has property of its own sufficient to meet its taxes. It is no doubt true that liens on the properties of some of the underliers would be adequate protection. The difficulty here is that the record is silent as to which companies have valuable properties. Some of the underliers, for example the Consolidated Traction Company, are in themselves nothing more than intermediate holding companies with little or no property of their own. Yet the tax on such company is one of the largest. A lien on their properties might be valueless. Before the creditors can be said to be protected by a first lien on the properties of underliers, it must be shown that prop-

erty of each underliers is worth the amount of the lien on that property. The fear that a particular lien would be valueless is not groundless if we consider the situation that has arisen in *Webster & Atlas National Bank v. Palmer*, now pending in this Court at No. 120 October Term, 1940, where the amount of the lien is now alleged to be greater than the value of the property.

To allow an advance in the absence of the requisite proof would clearly be unfair to creditors of the debtor. The Master has found that the payment of the underliers' taxes by the Trustees without requiring them to first establish their net earnings might result in preferences or overpayments (R. 67). While a possible preference might not injure the creditors of the debtor since the claims of the underliers when determined will be expenses of administration, any overpayment would seriously injure the creditors. If overpayments are made by the debtor, the overpayments will be made out of the funds and assets of the debtor and will reduce the assets available for the payment of the claims of unsecured creditors. The creditors will have their claims diminished to the extent of such overpayment.

Moreover, the Master to whom this matter was referred by the District Court found as a fact that the debtor Railways Company has substantial charges against some of the underlying companies, the amounts of which have not as yet been determined and are in dispute (R. 64). These charges will doubtlessly affect the amounts ultimately due the underliers on their use and occupancy claims and might in certain instances entirely erase the claims.

It would clearly be inequitable under these facts to allow the taxes of the underliers to be paid as an advance on use and occupancy payments which might never be proved.

CONCLUSION.

In conclusion, it is earnestly submitted that the fundamental error in the position of the petitioners arises out of their failure to differentiate between contractual obligations and tax obligations. The Pittsburgh Railways Company, by virtue of the covenants in the leases with the underliers, assumed an obligation to pay the taxes of the underliers. The filing of the petition for reorganization did not change the character of the obligation of the debtor.

Neither Section 124a of the Judicial Code nor the fact that the Trustees were utilizing the properties of the underliers in connection with their operation of the debtor's business, convert this unsecured contract claim into an administrative tax claim. Nor can any process of legal legerdemain enlarge the duties of the Trustees with respect to the tax obligations of a debtor lessee in reorganization to include the payment of taxes assessed and levied against its lessor underlying companies.

The only justification for paying these taxes is to construe them as advance payments for use and occupancy. Having failed to establish their net earnings, the measure of use and occupancy in cases of this genre, the underliers have established no tenable basis for any payments by the Trustees. Any payment at this time on this record would inevitably result in the undue favoring of the underliers at the expense of the unsecured creditors.

As it was pertinently stated by the learned Circuit Court of Appeals in the case at bar, at page 108:

> "It may be, as argued by the appellees, that in this case it is impossible fairly to allocate the net earnings of the system to the various leased lines.

In that case it may be necessary for the court to fix an allowance for use and occupation upon the basis of the fair value of the property actually used by the trustees. This we need not now determine for the court must first determine the property which is being used, the extent of its use and the net earnings being derived from it or its value. Until that is done any order made by the court would have no factual basis and would, therefore, be arbitrary and possibly confiscatory."

It is earnestly submitted that the decision of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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